# In the Supreme Court of the United States

OCTOBER TERM, 1969

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No. 872

QUALITY CHEVROLET COMPANY, INC., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW, JURISDICTION, AND STATUTE INVOLVED

The opinions below, the basis for this Court's jurisdiction, and the statute involved are adequately set forth in the petition.

### QUESTION PRESENTED

Whether, in determining the deduction for a reasonable addition to a reserve for bad debts under Section 166 of the Internal Revenue Code, there may be

taken into account anticipated losses of finance charges previously taken into income where such losses arise not from the worthlessness of the debts involved but from the prepayment of the debts.

## STATEMENT

During the taxable years here in issue (1960-62), petitioner was a corporation engaged in the business of selling automobiles and trucks as an authorized Chevrolet dealer in Wichita, Kansas. Most of its sales were credit transactions, the customers making small down payments and executing promissory notes, payable in installments, for the balances which then included finance charges and other incidental costs. (Pet. App. A2.)[1] Petitioner's usual practice was to sell the notes at a discount, with full or partial recourse, to finance companies which, in turn, paid petitioner the principal amount of the notes, crediting portions of the finance charges to dealer reserve accounts in petitioner's name. The dealer reserve accounts represented petitioner's participation in the finance charges, based on full collection of the notes by the finance companies, and, since petitioner was on the accrual method of accounting, it correctly reported as accrued income all amounts so credited. The portions of the finance charges not credited to the dealer reserve accounts represented the finance companies' profit on the transactions. (Pet. App. A2.)

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[1] "Pet." references are to the petition for certiorari. "Pet. App." references are to the Appendix thereto.

The dealer reserve accounts were maintained partly because Section 16-509 of the Kansas Statutes Annotated then required that a creditor reduce the finance charge when a debtor-customer prepaid the balance due on his note before its maturity date. Under the agreement between petitioner and the finance companies to which the customer notes here involved were sold, the finance companies reduced petitioner's reserve accounts by proportionate parts of the reductions in the finance charges in the event of customer prepayments; if the reserve accounts were not sufficient to cover those charges, petitioner paid the difference in cash. (Pet. App. A3.)

Petitioner, having elected to deduct bad debt losses on the reserve method of accounting, contended that under Sections 166(c) and (g) of the Internal Revenue Code of 1954, it was entitled to take into account, in determining a reasonable addition to its bad debt reserve each year, anticipated losses arising from customer prepayments. The Commissioner determined that Section 166 did not authorize anticipation of losses arising from prepayments but conceded that when a prepayment loss actually occurred (either by reduction in the dealer reserve account or upon a cash payment by petitioner if such account was insufficient), petitioner was entitled to a business expense or a loss deduction under Section 162(a) or 165(a) of the Code.[2]

Both courts below held, favorably to the Commissioner, that petitioner was not entitled to any deduc-

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[2] Section 162(a) allows a deduction for ordinary and necessary business expenses. Losses other than bad debt losses are deductible under Section 165(a).

tion under Section 166(c) or (g) for the asserted reasonable additions to petitioner's bad debt reserve for the years involved, because the prepayments of customer notes did not create any bad debts, as such, but rather resulted in the premature extinguishment of the original debts owing by the customers to petitioner (Pet. App. A3, A5, A17).

## ARGUMENT

The decision below, affirming that of the Tax Court, is correct. There is no conflict of decisions or any other basis for further review by this Court.

1. Section 166(a) of the Code allows a deduction for any debt that becomes worthless during the taxable year. As the Tax Court explained (Pet. App. A16), a debt becomes worthless within the meaning of Section 166 when it is uncollectible because the debtor is unwilling or unable to pay. Such worthlessness does not occur—and there is no "bad" debt loss—where, as in this case, the loss arises not from the debtor's unwillingness or inability to pay, but rather as a result of prepayment of the debt involved.

Because petitioner could not deduct the prepayment losses under Section 166(a) at the time they were actually incurred,[3] it may not take them into account in computing a reasonable addition to its reserve for bad debts under Section 166(c) or (g). Section 166(c), which authorizes the general use of the

[3] As we have noted (p. 3, *supra*), such losses would be deductible at that time under Section 162(a) or 165(a).

reserve method of accounting for bad debts,[4] provides that the deduction allowed thereunder for a reasonable addition to a reserve for bad debts, shall be "[i]n lieu of any deduction" allowed under Section 166(a). Section 166(g), which permits a reasonable addition to a reserve for bad debts for losses which arise from the liability of a dealer in property as guarantor, endorser, or indemnitor of debt obligations of customers, similarly allows a deduction "in lieu of any deduction" allowed under Section 166(a). The purpose of Sections 166(c) and (g) is to permit bad debt losses to be deducted in advance of actual worthlessness, by use of a reserve, in accordance with accepted accounting practice.[5] These provisions do not permit the deduction by means of an addition to the reserve of any amount that would not subsequently be deductible under Section 166(a) if the taxpayer did not elect to use the reserve method. Whether Sec-

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[4] Under this method, a taxpayer maintains a reserve account, the balance of which is to be adjusted at the end of each year, so that it equals that portion of current accounts and notes receivable that is reasonably estimated to become worthless in subsequent years. Any additions necessary to increase the reserve to its required level are currently deductible. When receivables become worthless during the year, the reserve account is decreased and no additional deduction is allowed.

[5] Absent specific statutory authorization, reserve accounting may not be used for tax purposes, and losses may be deducted by an accrual basis taxpayer only when they become fixed in fact and amount. *Brown* v. *Helvering*, 291 U.S. 193; *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906; *Villafranca* v. *Commissioner*, 359 F. 2d 849 (C.A. 6), certiorari denied, 385 U.S. 840; *Security Mills Co.* v. *Commissioner*, 321 U.S. 281.

tion 166(c) or (g) is applicable, the reserve addition must be based on the worthlessness of debts—arising as a result of the unwillingness or inability of the debtor to pay—just as the deduction for actual bad debt losses permitted under Section 166(a) must be based on such worthlessness.

Petitioner contends (Pet. 11-13) that in computing its bad debt reserve, it may take into account anticipated reductions in finance charges because it was required to indemnify the finance companies for a portion of the losses arising from customer prepayments and thus was an "indemnitor of debt obligations" within the meaning of Section 166(g)(1)(A). This argument, like the entire petition, is based on the false premise that prepayment losses are "bad" debt losses allowable under Section 166, and that petitioner suffered a "bad" debt loss when its dealer reserve accounts were reduced or it made cash payments to the finance companies. As both courts below held, however, the prepayment losses can only be viewed as rebates or refunds by petitioner of amounts previously credited to its dealer reserve accounts and not as "bad" debt losses.[6] The prepayments merely extinguished a portion of petitioner's original obligations; they did not arise from any debt becoming bad or worthless. Cf. *Citrus Motors Ontario, Inc.* v. *United States*, 249 F. Supp. 425, 426 (S.D. Calif.)

2. There is no conflict between the decision below and *Commissioner* v. *Hansen*, 360 U.S. 446. The

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[6] The legislative history of Section 166(g), cited and relied upon by petitioner (Pet. 12-13), is not to the contrary, as the Tax Court explained (Pet. App. A16).

taxpayer in *Hansen* also was an automobile dealer who discounted customer notes to financial institutions in return for cash payments and dealer reserve account credits. The question in that case, however, was whether the amounts so credited were includible in the dealer's income in the taxable year in which the credits were made or in a later year when the finance charges were actually paid. Since the taxpayer in *Hansen* was on the accrual method of accounting, this Court determined that the amounts credited constituted income when the credits were made.[7] *Hansen* thus had nothing whatever to do with bad debt reserves or the effect thereon of customer prepayments.

Petitioner nevertheless argues (Pet. 8-13) that a conflict exists on the grounds that, contrary to this Court's decision in *Hansen*, the court below found (1) that petitioner was not an indemnitor of customer obligations and (2) that the prepayment losses incurred by petitioner were unrelated to existing debt obligations. These arguments are without merit. The Tenth Circuit did not hold that petitioner was not an indemnitor of debt obligations; it held only (Pet. App. A5) that in indemnifying prepayment losses, petitioner did not suffer bad debt losses. There is nothing in the Tenth Circuit's opinion that suggests that petitioner would not be entitled, in computing its reserve for bad debts, to take into account losses it was required to indemnify as a

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[7] *Hansen* was legislatively modified by the Dealer Reserve Income Adjustment Act of 1960, P.L. 86-459, 74 Stat. 124, but the modifications are not pertinent here.

consequence of a customer's unwillingness or inability to pay a debt obligation. As for the contention that the court of appeals misconceived the relationship between petitioner's losses and the debt obligations, we need only point out that the court made clear in discussing the reserve method of accounting for bad debts (Pet. App. A4) that a loss could be allowed under Section 166(c) or (g) only if it related to an existing debt obligation which might ultimately result in a "bad" debt loss (Pet. App. A4, n. 4). This Court's discussion in *Hansen* does not conflict in substance or in principle with the result in the instant case.

3. There is likewise no conflict between the decision below and *Wilkins Pontiac* v. *Commissioner*, 298 F. 2d 893 (C.A. 9); *Bolling* v. *Commissioner*, 357 F. 2d 3 (C.A. 8); and *Foster Frosty Foods, Inc.* v. *Commissioner*, 332 F. 2d 230 (C.A. 10). In those cases, which were decided prior to the enactment of Section 166(g), the appellate courts rejected the Commissioner's policy under Section 166(c) of disallowing *any* addition to a bad debt reserve based upon anticipated losses on installment notes which a retail dealer discounted to a financial institution. The Commissioner's position was that no debt existed between dealer and customer after assignment of the customer's note, thus foreclosing the possibility of a dealer's bad debt loss in the event of a subsequent customer default. In enacting Section 166(g), Congress adopted the rule of the cited cases that a reasonable addition to a reserve for bad debts is not to be disallowed with respect to contingent liability on

discounted notes merely because the taxpayer stands only as a guarantor or indemnitor.

In each of the cited cases, the losses which the taxpayer sought to take into account for bad debt reserve purposes were losses resulting from the worthlessness of the debts in issue. None of the cases involved the question presented here—whether losses resulting from prepayments rather than worthlessness may be taken into account for such purposes. Petitioner acknowledges this fact but insists (Pet. 14) that "It makes no difference whether the loss is due to default or prepayment." We disagree. A default loss gives rise to a bad debt; a prepayment loss does not. This is the difference that both courts below found to be critical. It is also the difference that renders the cited cases inapposite.[8]

4. The underlying question in this case was decided long ago in *Brown* v. *Helvering*, 291 U.S. 193. That case has stood the test of time, and there is no occasion for reexamining it now.

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[8] If the cases cited by petitioner are at all relevant, they support the Commissioner's position here. Thus, in *Wilkins Pontiac, supra*, the court stated (298 F. 2d at 895), "it would seem that * * * [a Section 166 reserve] must relate to an existing debt as to which the taxpayer [dealer] in the ordinary course of business may ultimately sustain a *bad debt loss*." Similarly, in *Foster Frosty Foods, Inc., supra*, the court stated (332 F. 2d at 233) that a bad debt reserve is intended "to allow a deduction against current income for *bad debts* attributable to such income but arising later." (Emphases added.)

## CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ERWIN N. GRISWOLD,
*Solicitor General.*

JOHNNIE M. WALTERS,
*Assistant Attorney General.*

MEYER ROTHWACKS,
JANET R. SPRAGENS,
*Attorneys.*

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